Finding a path to growth

PwC's 2021 Budget Insights

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Introduction

Budgets tell stories: what happened last year? were expectations met? how will things be different next year? what can we expect our economic fortunes to be over the coming years?

The stories about 2020 that are embedded in the 2021 Budget are remarkable on any measure. At this time last year, who could have predicted that Papua New Guinea (PNG) would be rocked by:

- a global oil price war, with a 65% quarterly fall in the price of oil in the March quarter
- a decline in global economic activity as COVID-19 rolled around the globe. This was reflected in
  - a progressive global slowdown of economic activity that put further downward pressure on PNG's export opportunities
  - domestic restrictions on activity to suppress the COVID-19 virus. While the number of confirmed COVID-19 cases in PNG remained low until July, economic activity was dulled by social distancing obligations and restrictions on movement imposed in Port Moresby as cases rapidly increased.

For a country so dependent on the export of commodities, an oil war and a slow-down in global economic activity provided an incredible challenge, only compounded by the domestic challenges of a pandemic.

But for once, PNG is not alone in facing these challenges; all countries, to varying degrees, face the prospect of lower growth, more government debt and higher unemployment.

Even though the global environment has shifted, the PNG Government still holds out ten Budget and Reform priorities (see Box 1) against which it wants to be judged, presumably with an acknowledgement that expectations need to be reset as to what can actually be achieved in the midst of a global downturn.

In this paper we briefly consider:

- how the international environment has changed over the past year, and the prospects for improvement as outlined in the Budget (chapter 1)
- the PNG Government's revised fiscal position (chapter 2)
- specific tax changes set out in the Budget (chapter 3).

Box 1 - Ten principles underpinning the National Government's 2021 Budget and Reform priorities

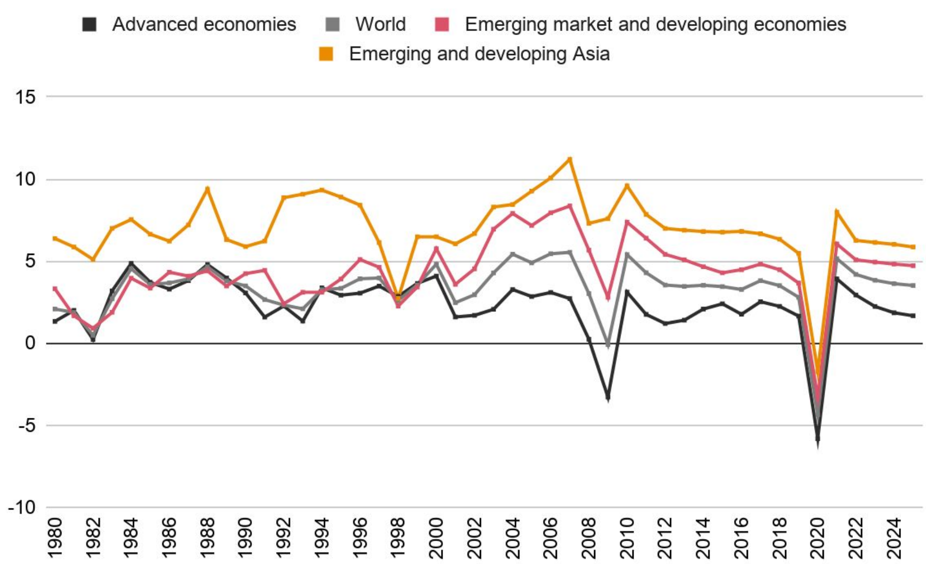
1. Spend the money we have more wisely
2. Raise the revenues more fairly
3. Finance the debt more cheaply
4. Leverage friendly international support more intelligently
5. Focus on growth in the agriculture, forestry and fishing sector, SMEs and the informal economy
6. Distribute resource benefits more equitably
7. Stimulate non-resource growth back to at least 5% annually
8. Comprehensive Government state owned enterprise (SOE) reform program for cheaper energy, internet and water
9. Getting foreign exchange flowing more freely
10. Create at least 10,000 jobs annually

1. The PNG Economy

1.1 The global economic environment

2020 will be remembered as the year when the global community, almost as one, saw a contraction to the degree that economic growth became negative (Figure 1). While growth projections coming into 2020 were less than stellar, no-one foresaw the oncoming pace and depth of the 2020 contraction.

Figure 1: IMF real GDP growth forecasts (%)

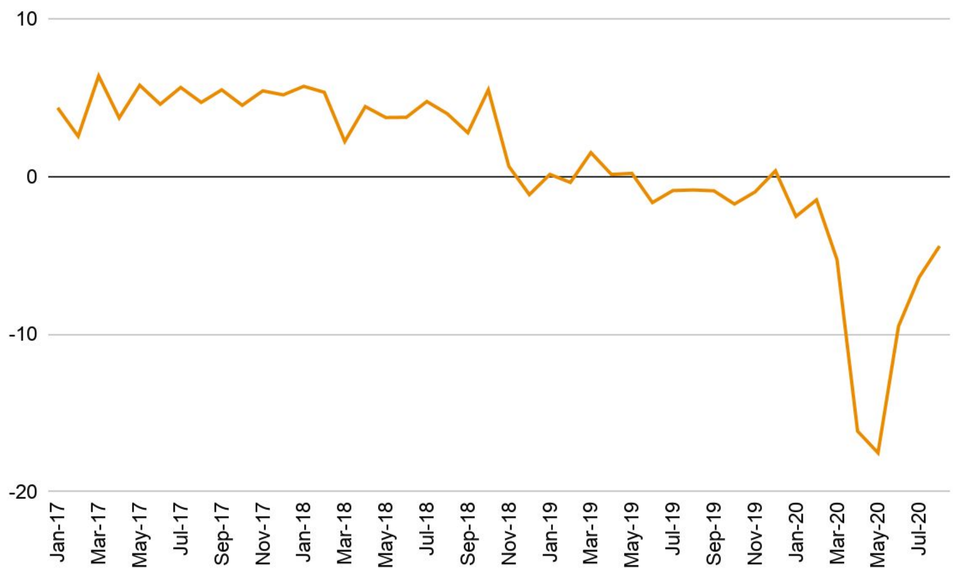


Source: IMF

It would be convenient to say that this is simply the fault of COVID-19, but that would miss a couple of key drivers particularly pertinent to PNG.

First, as we noted in last year's Budget commentary, even before COVID-19, world trade had stagnated (see Figure 2). While driven by a range of factors, with ongoing trade tensions between China and the United States at its heart, even before COVID-19 we continued to see the weakest levels of trade growth since the aftermath of the Global Financial Crisis (GFC) in 2009.

Figure 2: Annual growth in world trade (% change by volume, seasonally adjusted)



Source: Netherlands Bureau of Economic Policy Analysis

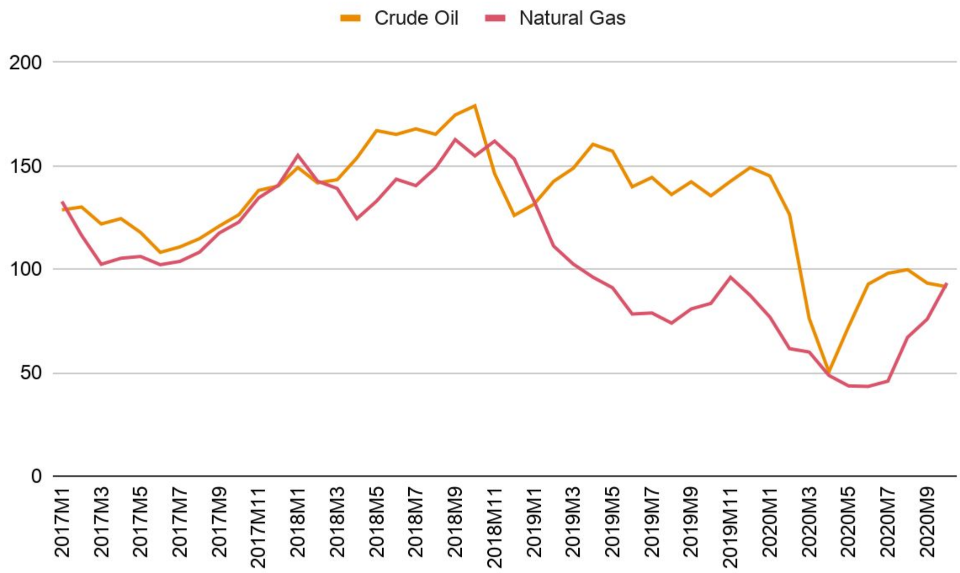
Such a poor outlook for world trade is generally a bad omen for a country, like PNG, that is so dependent on the export of commodities.

Second, the general malaise in trade was specifically challenging for PNG given, as shown in Figure 3:

- the fall in liquid natural gas (LNG) prices in 2020 after the late 2019 rally
- a 65% fall in oil prices at the beginning of 2020, triggered by a dispute between Russia and Saudi Arabia in response to Russia's refusal to reduce oil production in order to keep prices for oil at ‘moderate levels’.

While prices have recovered in the order of 50%, they remain at around two-thirds of 2019 levels (see Figure 3).

Figure 3: Monthly price indices for crude oil and natural gas



Note: Crude Oil (petroleum), Price index, 2016 = 100, simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh
Natural Gas Price Index, 2016 = 100, includes European, Japanese, and American Natural Gas Price Indices
Source: IHS Markit

The trajectory of the global economy (see Figure 1) is wrapped in uncertainty.

In it's October Economic Outlook, the International Monetary Fund (IMF) noted that 'the persistence of the shock remains uncertain and relates to factors inherently difficult to predict, including the path of the pandemic, the adjustment costs it imposes on the economy, the effectiveness of the economic policy response, and the evolution of financial sentiment'.[1]

Clearly, the health status of major economies is the fundamental risk to world growth. Here we have contrasting outlooks, with:

- the downside heightened with the acceleration of the COVID-19 pandemic in Europe and North America
- considerable hope that a vaccine will start to meaningfully roll out in the first quarter of 2021 with distribution over the remainder of the year.

History tells us that recovery from a pandemic recession traditionally happens faster than from a 'traditional' recession. And so the relatively quick return to global growth shown in Figure 1 is plausible (even though growth may be uneven across countries).

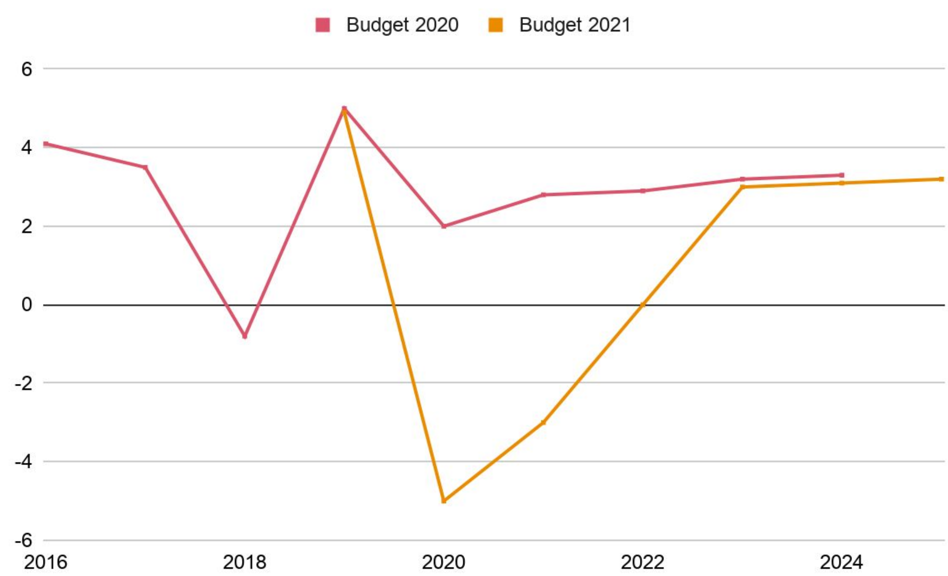
[1] International Monetary Fund (2020), Economic Outlook, p.7

1.2 The domestic economy

Economic growth

Not unexpectedly given the external shock described above, PNG's forecast 2020 economic growth (gross domestic product - GDP) of -3.8% is well below the forecast provided in the 2020 Budget (2%) (see Figure 4).

Figure 4: Real GDP growth (%)



Source: Budget 2020 and 2021

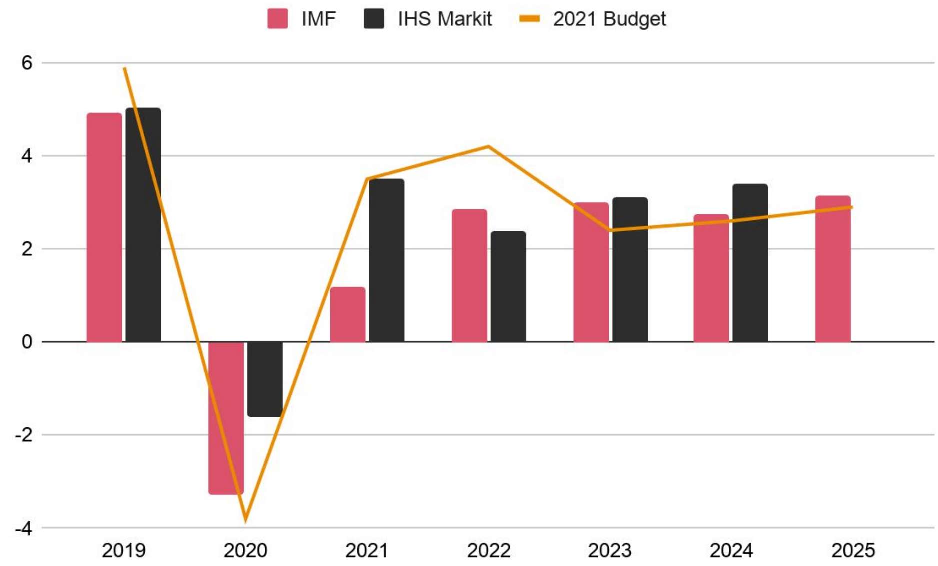
While the decline is most shaped by the global influences of the oil price war and COVID-19, domestically the decline was also materially shaped by specific events including:

- the indefinite closure of the Porgera mine
- lower gold output from Lihir mine.

The implication of the forecast shown in Figure 4 is that GDP will return to 2019 levels early in 2022. While the growth in 2021 is projected to be higher than the pre-COVID-19 growth forecast for the same year, it is off a lower 2020 base and so recovery is not forecast within the next 13 months; the current downturn will result in a loss of just over two years of growth.

While forecasting is challenging at the best of times, like last year, we note that the Treasury growth forecasts are broadly in line with other forecasters (see Figure 5).

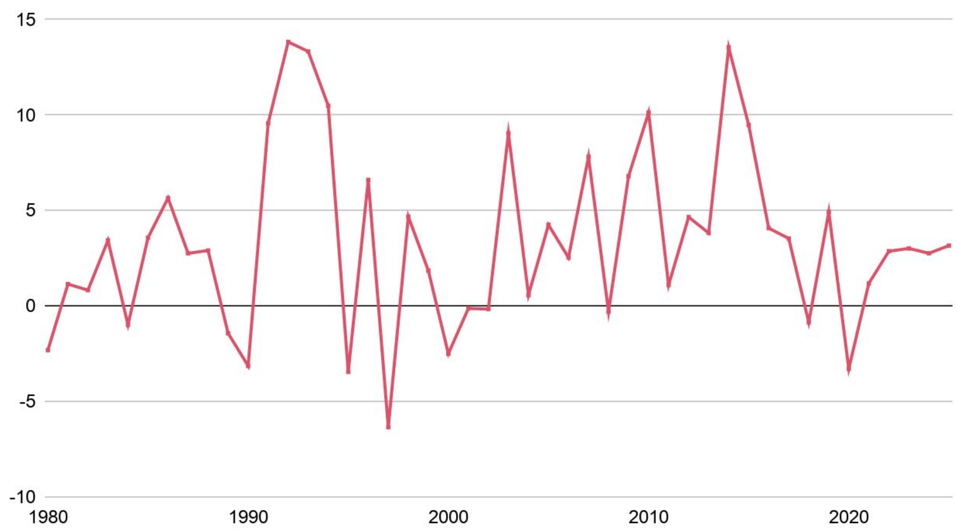
Figure 5: Comparison of real GDP growth forecasts



Source: Budget 2021, IMF, IHS Markit

Unlike many advanced economies, the economic position that PNG now finds itself is not unprecedented. Indeed, as shown in Figure 6, unfortunately, instability has been a hallmark of the PNG economy and while the major drivers of this year's growth drop may be different (an international oil price war and a global pandemic), the challenge to grow out of negative growth remains.

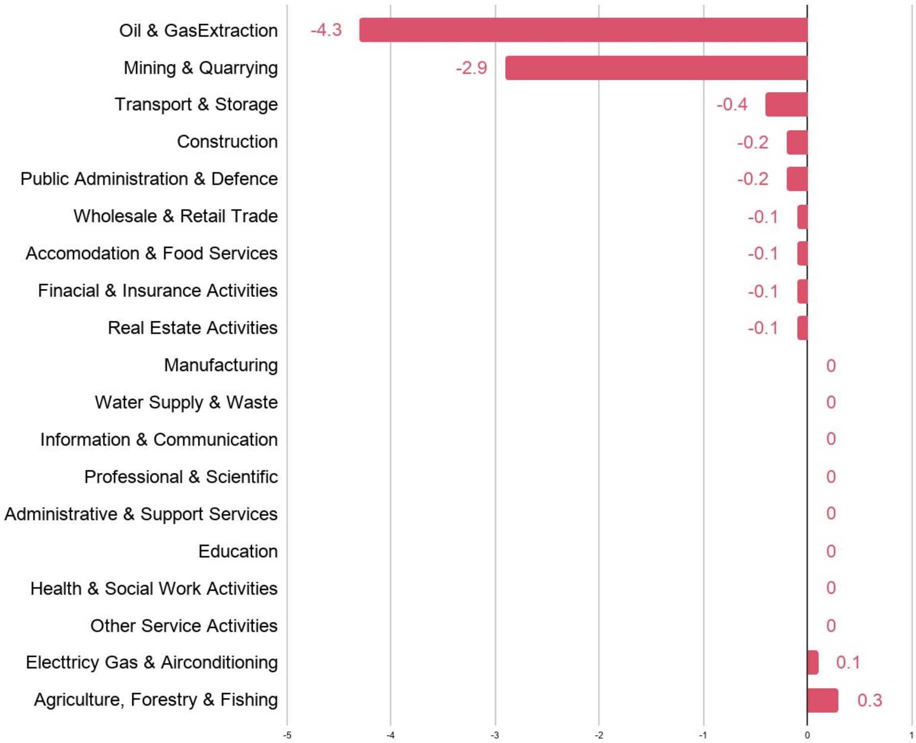
Figure 6: Historic and forecast real GDP growth (%)



Source: IMF

The key drivers of the fall in economic growth are related to the extraction of natural resources (see Figure 7). Indeed, while negative, and possibly because this analysis does not capture the impact of the downturn on the informal economy, the decline in economic value in other sectors is somewhat surprising.

Figure 7: Change in contributions to growth between 2020 and 2019 (%)

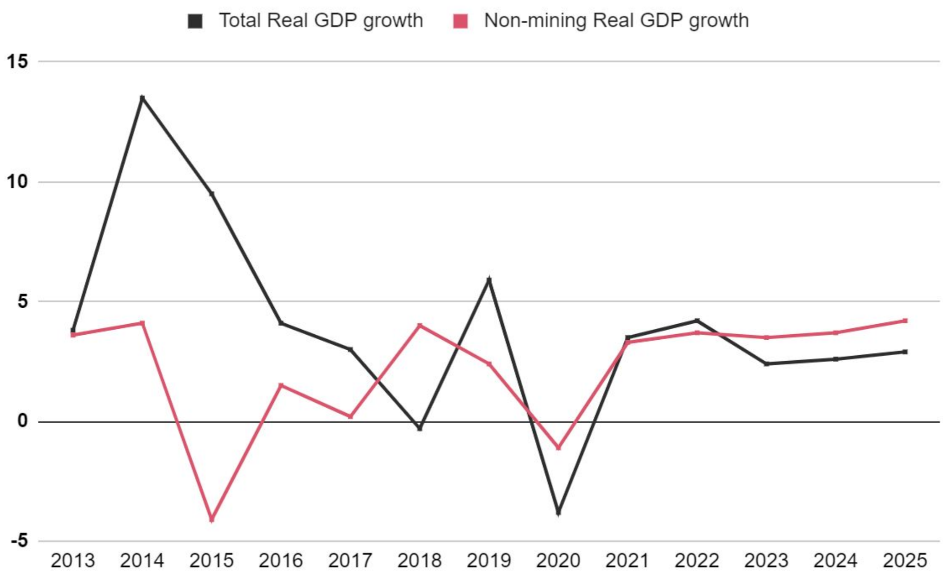


Source: Budget 2021

Non-resource GDP is the best measure for economic activity in which most Papua New Guineans are involved, excluding output from the largely foreign-owned extractive sector.

As suggested by the results in Figure 7, GDP in the non-resource sector fell, but did not fall to the same degree as in the mining sector (see Figure 8).

Figure 8: Real GDP growth in the non-mining sector and the total economy (%)



Source: Budget 2021

The interesting element of the future projections (in aggregate in Figure 8) is that the Government is forecasting that from 2023 the non-mining sectors will grow faster than the mining sector, by about 1% annually. While it has certainly been the ambition of governments to grow the non-mining sector faster, as can be seen in Figure 8, we have not seen this as a consistent outcome. Such an outcome, if achieved, would be welcomed as a step towards greater needed diversification of the economy.

But this might not be an outcome given that there is upside in some of the Government's forecasts in that they do not include:

- full reactivation of the Porgera mine, which itself could add something like 2% to GDP
- any new additional resource projects that could come on stream.

If these come to fruition the projected shift in emphasis to non-mining GDP growth would likely be swamped.

Finally, it would be remiss, given the political instability that surrounds this year's Budget, if we did not also point out that political instability likely has an economic cost that lowers PNG's growth prospects. IMF researchers have previously noted that:

> Our results are strikingly conclusive: … political instability reduces GDP growth rates significantly. An additional cabinet change (a new premier is named and/or 50 percent of cabinet posts are occupied by new ministers) reduces the annual real GDP per capita growth rate by 2.39 percentage points. This reduction is mainly due to the negative effects of political instability on total factor productivity growth, which account for more than half of the effects on GDP growth. Political instability also affects growth through physical and human capital accumulation, with the former having a slightly larger effect than the latter. These results go a long way to clearly understand why political instability is harmful to economic growth. It suggests that countries need to address political instability, dealing with its root causes and attempting to mitigate its

effects on the quality and sustainability of economic policies engendering economic growth.[2]

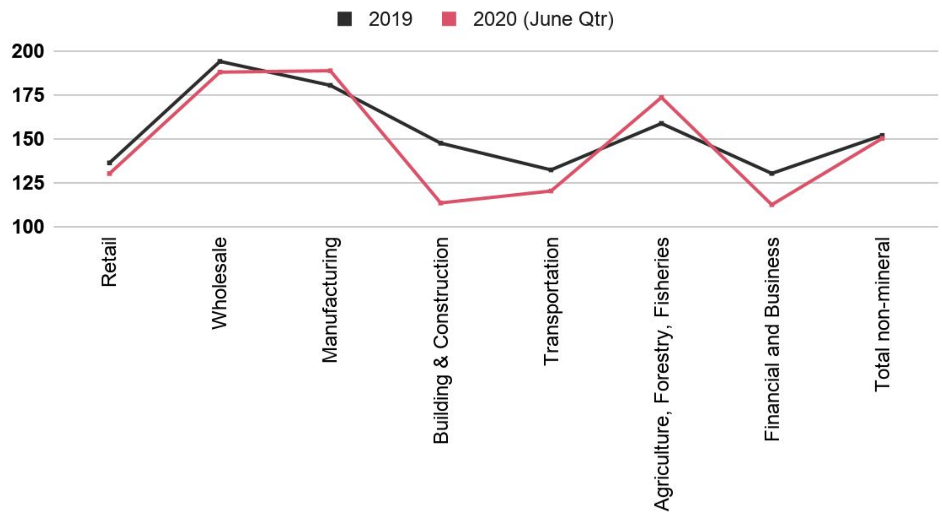
This seems so self-evident that it should not be contentious; the political instability in PNG has a cost that the community as a whole bears.

Employment

As a consequence, and again not surprisingly, the Government's objective of creating at least 10,000 jobs annually (see Box 1) was not met in 2020, with employment falling in both the non-mineral sector (the eighth consecutive year of declines) and the mineral sector.[3] A couple of observations are particularly interesting:

- As shown in Figure 9, it appears that the manufacturing and agriculture sectors have improved their employment in spite of the broader economic decline.
- The Government notes that the 'The negative impact of COVID-19 on formal employment is … implied to be concentrated on employees earning below the tax-free threshold'. The concern is that informal employment has also been disproportionately hit.

Figure 9: Employment index (March 2002 = 100)



Note: June 2020 Qtr data is provisional
Source: Budget 2021

Inflation

The Budget reasonably forecasts a small transitory uptick in inflation as the economy picks up in 2021, before dipping down slightly (see Figure 10). Given the easing of monetary policy in light of the COVID-19 slowdown it is difficult to see inflation moving considerably up. We note that the Budget inflation forecasts split the middle between those of third part commentators (see Figure 10).

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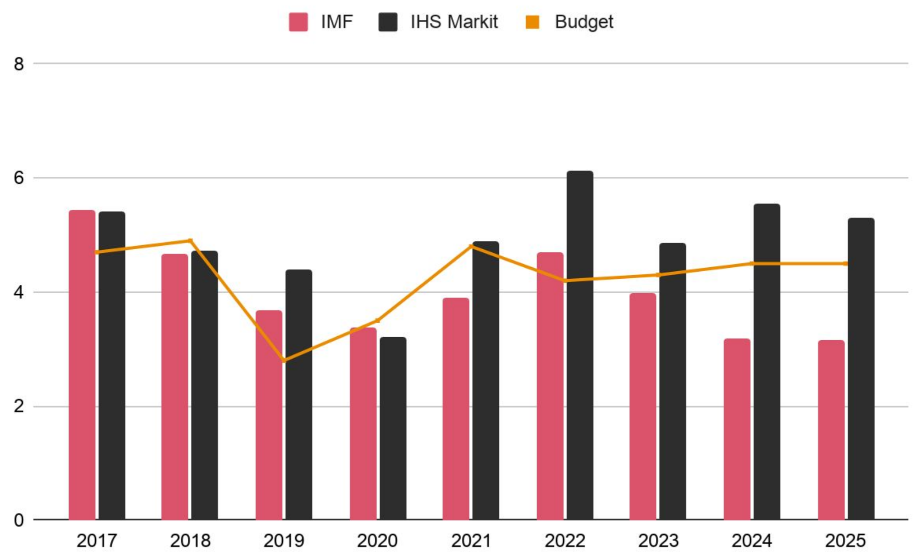
[2] Ari Aisen & Francisco Jose Veiga (2010), How Does Political Instability Affect Economic Growth? IMF Working Paper WP/11/12

[3] We note that while the Government has set itself a jobs target (see Box 1), the Budget papers do not actually specify the specific change in jobs achieved (instead referring to the indices shown in Figure 9)

Figure 10: PNG inflation



Source: Budget 2021, IMF, IHS Markit

Foreign exchange availability

Currency availability continues to be an ongoing challenge for the PNG business community and ‘getting foreign exchange flowing more freely’ is again one of the Government’s stated principles underpinning the Budget and its reform agenda (see Box 1).

The rationing of foreign reserves over the past five years has artificially suppressed import demand for foreign currency. Owing to PNG’s high level of dependence on imports for capital and consumer goods, there has been a resultant significant suppression of investment and consumption activity in the economy.

The measures under the current Budget will both assist and harm the availability fo foreign exchange as:

- access to external financing will provide an injection into foreign exchange reserves reserves that will facilitate the easing of the foreign exchange imbalance, but
- the fiscal deficit financing under a quantitative easing (QE) program run by BPNG will have the opposite impact on FX reserves.

Indeed, the Budget papers note that ‘... legacy issues such as foreign exchange shortages will continue to be impediments towards the improved growth of the business environment in the non-mineral sector’.

2. The Government's Fiscal Position

2.1 Revenue

An objective of successive governments has been to raise the level of taxes collected to better be able to invest in physical and human capital to advance development.

Surprisingly given the economic environment described in the previous chapter, tax revenues have held up remarkably well and are projected to be just 1.7% below the 2020 Budget projections (see Figure 11), with total revenue and grants down 7.8%.

Figure 11: Revenue changes since the 2020 Budget (Kina, million)

	2019 Budget	2020 Budget	2021 Budget	Difference
Tax Revenue	**10,918.10**	**11,307.80**	**11,109.7**	**-198.10**
Grants	1775.6	932.1	1008.3	76.20
Other Revenue	986.8	1855.5	877	-978.50
TOTAL	**13,680.50**	**14,095.40**	**12,995.00**	**-1,100.40**

Source: Budget 2021

This relative bullish projection for revenue growth is justified in the Budget the following terms, underpinned by a post-COVID-19 recovery:

> Revenues in 2021 are expected to be supported by a recovery in economic growth (in both the non-mining and mining sector). Specifically, higher government spending, public injections to private sector credit growth, an expected broad-based recovery in export commodity prices, higher anticipated growth in the Agriculture, Forestry and Fishing sector and progress on the revised Medium Term Revenue Strategy (MTRS) initiatives.

Clearly, a lot has to simultaneously go right for the revenue projections to hold true, and history suggests that this will not occur. Hence, we are concerned that an overly rosy picture of revenue recovery is painted in the Budget.

2.2 Expenditure

Total expenditure in the 2021 Budget is projected to be K19,607.8 million, up from K18,726.5 in the 2020 Budget (i.e. an increase of 4.7%).

The forecast pattern of government expenditure is shown in Figure 12, with the largest three areas of expenditure (consistent with the previous two Budgets) being:

- Administration/Miscellaneous (27.3%)
- Provinces (20.1%)
- Debt Services (12.0%).

A number of other notable things stand out in Figure 12:

- debt servicing slightly is projected to reduce (from 12.5% to 12.0%) as interest rates have come down
- expenditure on health is projected to fall during an ongoing global pandemic.

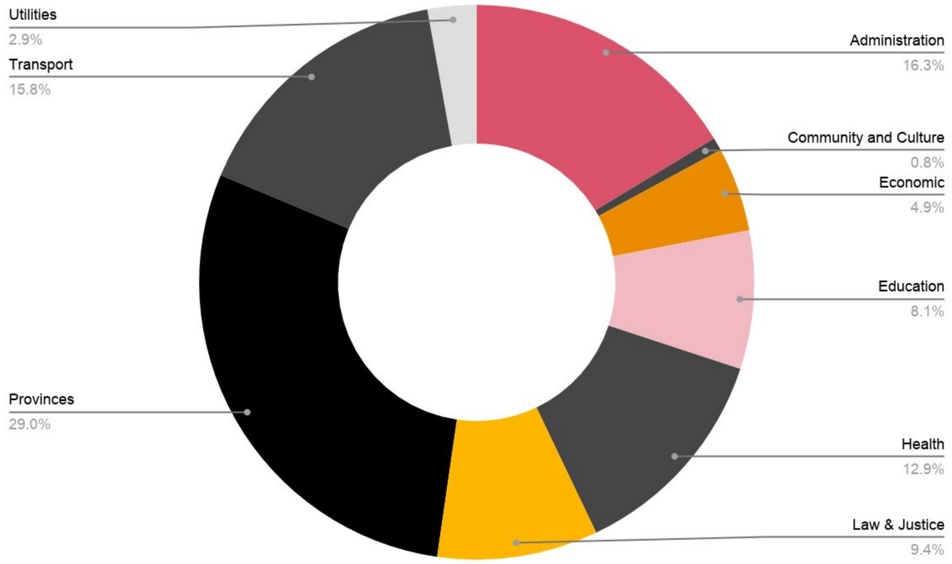
Figure 12: Expenditure by sector as a % of the total budget

	Budget 2019	Budget 2020	Budget 2021
Administration/Miscellaneous	25.2	21.5	27.3
Community and Culture	0.9	0.7	0.5
Debt Services	12.3	12.5	12.0
Economic	4.6	4.8	3.4
Education	8.5	9.0	5.6
Health	9.6	10.4	8.9
Law & Justice	8	9.7	6.5
Provinces	19	23.7	20.1
Transport	8	6.4	11.0
Utilities	3.8	1.2	2

Source: Budget 2019, Budget 2020 and Budget 2021

Drawing on the data from Figure 12, a more down-to-earth perspective of the relative focus of spending can be discerned by excluding Debt Servicing and Miscellaneous categories, as shown in Figure 13.

Figure 13: Expenditure in 2021 by sector as a % of total expenditure (net of Debt Servicing and Miscellaneous spending)



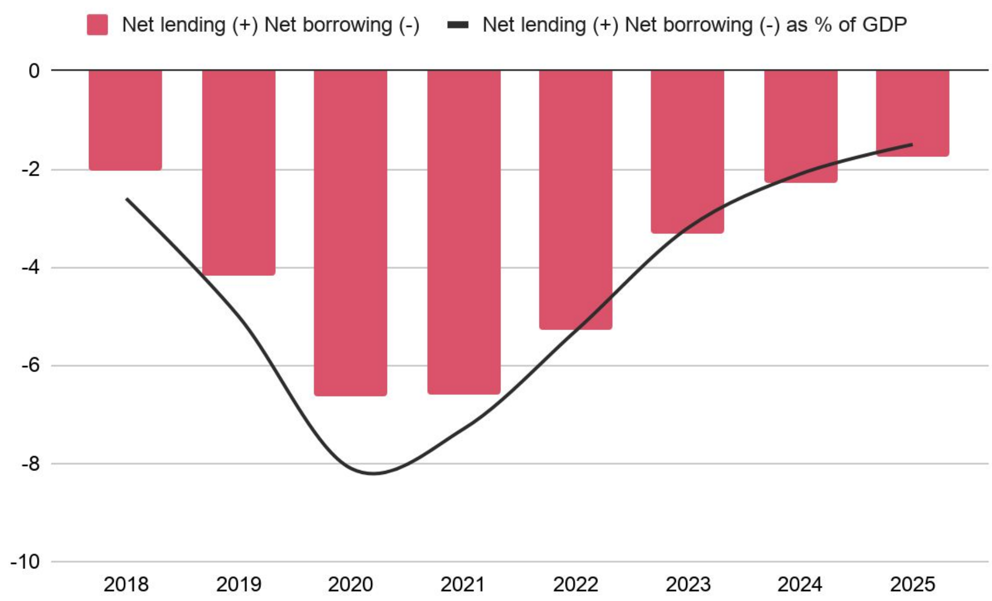
2.3 Debt

In 2021, with total revenue of K12,995.0 million and total expenditure of K19,607.8 million, the resulting fiscal deficit is K6612.8 million (7.3% of GDP).

Figure 14 shows the projected deficits in millions of Kina and as a percentage of GDP. The pandemic put back the path to getting the Budget into surplus (the 2023 forecast of a deficit of 1.8% is now 3.2%).

Indeed, we are sceptical that the level of spending constraint and/or tax collections required to achieve the consistent reduction in deficits shown in Figure 14 can be maintained.

Figure 14: Net borrowing (Kina, million and % of GDP)

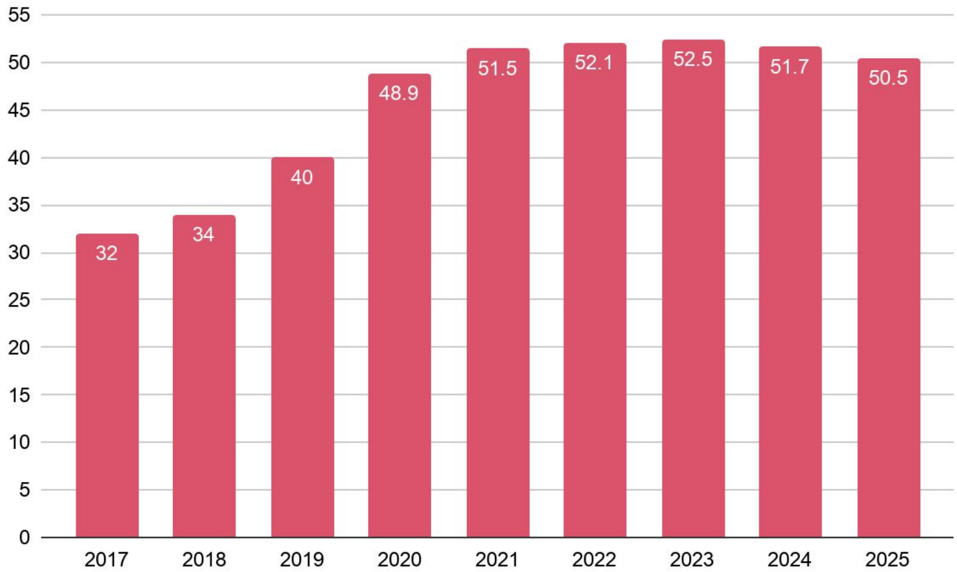


Source: Budget 2021

This K6612.8 million shortfall will be financed through external (K4612.8 million) and domestic (K2000.0 million) borrowings to meet the total funding requirement for 2021 Budget appropriation of K19,607.8 million.

The Fiscal Responsibility Act put a fiscal constraint on the government in that it limited debt levels to 45% of GDP. Despite this legislative barrier, the deficit this year will increase the level of public debt, excluding valuation changes, to K46,464.4 million, or 51.5% of GDP (excluding outstanding arrears). As shown in Figure 17, debt is not projected to fall below the 45% threshold.

Figure 15: Debt as a percentage of GDP



Note: 2020 refers to the 2020 Supplementary Budget
Source: Budget 2021

Even though in a lower interest rate environment, debt servicing costs are projected to increase in absolute terms and as a percentage of total expenditure (see Figure 18).

Figure 16: Debt servicing costs

	2020	2021	2022	2023	2024	2025
Debt servicing (Kina million)	2064.4	2270.8	2222.2	2527.4	2799.1	2994.1
Debt servicing as a % of total expenditure	11.5%	11.6%	10.9%	12.4%	13.2%	13.4%

Note: 2020 refers to the 2020 Supplementary Budget
Source: Budget 2021

3. Taxation Developments and Amendments

The 2021 Budget did not include comprehensive tax changes or developments, but does set the platform for more policy changes to be considered in the 2022 Budget process. The 2021 Budget sees a return to discussion on the Medium Term Revenue Strategy (MTRS). As with the 2020 Budget, this Budget may be notable for the number of measures which were mooted but ultimately not announced or even mentioned, including no:

- announcement regarding the proposed rewrite of the Income Tax Act*,* which was originally forecast to commence operation from 1 January 2021 and had been subject to calls for submissions on draft legislation
- announcement regarding the commencement of the Tax Administration Act.
- introduction of the proposed capital gains tax regime which had undergone consultation with stakeholders during the year, including the preparation of draft legislation.

What the Treasurer has delivered however is a budget that is focussed on relatively targeted and modest tax relief measures which look to remove some of the tax burden on consumers and Small to Medium Enterprise (SME) importers. Most of the budget recovery will be driven by ongoing economic recovery, rather than wholesale reform agendas.

The Budget does contain commentary on the potential introduction of policy reform agenda in relation to matters in 2021, particularly around long mooted telecommunications taxes and a banking levy, however no further guidance was provided in the Budget regarding the consultation and implementation of these potential changes.

3.1 No new substantive policy changes implemented

Throughout the first half of 2020, progress was made on the rewrite of the Income Tax Act consistent with the Government's prior policy directives laid out on 2018's MTRS. Treasury, in conjunction with its development partners, held consultation discussions on draft legislation and called for submissions looking towards a potential implementation date of 1 January 2021. Treasury had indicated that it had intended to pass the new Act as part of the 2021 Budget process.

In the relatively recent supplementary Budget, Treasury indicated that it was "unlikely" to pass the new Act owing to the impact Covid-19 has had on its ability to properly undertake consultation of the new Act. Whilst it is not clearly articulated in such terms, the fate of the new Tax Administration Act, which was passed but not enacted in the 2018 Budget, appears to be tied to the new Act, and was not foreshadowed to be implemented in 2021.

The remainder of the Budget papers and amending legislation states that there are no substantial revenue policy shifts or implementation of new or modified collection measures.

3.2 Forecast policy discussions for 2021

Similar to the 2020 Budget, Treasury has foreshadowed a number of policy areas that it it intends to undertake consultation on in 2021, with a view to implementation at a later date, including:

- continuing to set out that Department of Planning and Monitoring, Treasury and the IRC will undertake their review of the Infrastructure Tax Credit Scheme, a measure discussed in the 2020 Budget
- looking to impose a 'new tax on the banking sector', intending to introduce it in 2021. This was forecast in the 2020 Budget, but Covid-19 delayed discussions with the banking sector. Details in relation to how such a levy or tax will be determined or calculated has not been provided

- announcing it will work with the National ICT Authority of PNG to introduce a universal access levy regime. Again, this is a measure flagged in the 2020 Budget and Treasury suggests a levy will be imposed on turnover rather than profits. It further discusses potential consideration of a ‘mutualisation policy’ relating to the sharing of telecommunications infrastructure. Finally in relation to telecommunications, it foreshadows an increase in telecommunication license fees noting that the current license fees are set “at too low a level”
- considering reforms led by the Securities Commissioner improve the ability for PNG SMEs to raise funds both domestically and internationally. The Budget states that Ministers have identified changes required to the Securities Act to enable this however no specifics were provided.
- reviewing the ‘Fuel Industry’ including the Napa-Napa Refinery Agreement. The Budget specifically references taxation arrangements and excise taxes on fuels.

3.3 Tax changes and corrections

A number of legislative changes have been made to the Income Tax Act to amend provisions introduced or made unclear from the 2020 and earlier Budgets, including:

- **SME Taxation Adjustments:** The measures introduced in the 2020 Budget to implement a new SME taxation regime have been adjusted slightly to improve the simplicity of the regime and attract more participants into the tax net. The measures will apply in 2021 after the issue of a Gazettal Notice, and adjust the regime to:
  – impose a fixed amount of K250 per year for small businesses with a turnover of less than K60,000 per annum;
  – Apply a quarterly turnover tax for businesses whose annual turnover is more than K60,000 and less than 250,000. They will pay a turnover tax of 2% on turnover above K15,000 for the quarter, plus a quarterly payment of K62.50.
- **Clarification of Tax Loss Deductibility:** In the 2019 Budget the Income Tax Act was amended to limit the carry forward period for tax losses incurred after 1 January 2019 to seven years (for non-resources companies) and 20 years (for resources companies). The 2020 Budget sought to clarify that losses incurred in years prior to 1 January 2019 would only be eligible to be carried forward a further 7 years (20 years for resources companies). The technical amendments in the 2020 Budget were however, ambiguous. Amendments are implemented to clarify the treatment discussed in the 2020 Budget, in that losses in existence prior to 1 January 2019 can only be carried forward and deducted a maximum of their old carry forward period or a further 7 years. Unfortunately it appears this has not catered for resource companies and it looks like further amendments may be required to achieve the policy intent from prior budgets.
- **Remittance of Prescribed Royalties Withholding Tax:** As requested by the Commissioner General in his pre-Budget submission, the Budget amends the collection mechanism for the Prescribed Royalties Withholding Tax with the requirement that resource developers must deduct and remit a 5% tax directly to the IRC rather than the obligation sitting with the relevant regulator. The tax will be due and payable within 21 days of the month the royalty was paid or credited to the customary landowner. Oddly enough this change is retrospective to 1 January 2020 per the legislative amendments, which contradicts the Budget commentary which intends to apply the withholding after 1 January 2021. It would be expected the IRC will release guidance for withholders on the administrative application of the withholding in due course, particularly to payments that have already been made.
- **Adjustment to Provisional Tax Payment Dates:** The 2020 Budget implemented proposals that allowed for the adjustment of provisional tax payment dates for taxpayers with year ends other than 31 December 2020. Amendments have been incorporated to more accurately align these due dates with December balances, with provisional tax payments now being due 120, 210 and 300 days from the end of the preceding year. The amendments have not corrected the due date for Advanced Payment Tax estimates for resources companies with different year ends, meaning they continue to be due on 31 March.

Disappointingly, corrections which had previously been considered to make it clear that the thin capitalisation limit reductions for resource companies from 3:1 to 2:1 should have applied to income years after 1 January 2021, have not been implemented in the Taxation Bills. Technical corrections to correct the duplication of section numbering that occurred with the introduction of the SME tax regime has also not been implemented.

Whilst it is pleasing to see some of the legislative amendments progress and resolve technical anomalies and errors in the Income Tax Act, further comprehensive changes to areas still requiring amendment or redress remain in the current act. However, these may be dealt with as part of the rewrite of the Income Tax Act.

3.4 Changes to tariffs, excise and penalty provisions

The Budget revenue strategy for 2021 makes modest adjustments to a number of tariffs and looks to increase penalties for breaches of the Customs Act for illegal sale and imports of certain products targeting the illicit trade of tobacco and alcohol. These changes introduced include:

- **Increase in penalties for breaches of the Customs Act:** The amendment bills look to impose greater penalties on certain individuals, including importers, brokers and so on, who breach provisions of the Customs Tariff Act. Treasury's views were that previous penalty provisions were ineffective and did not deter breaches. Specific provisions are introduced to target greater penalties for smuggling of tobacco into PNG.
- **Introduction of a hybrid and electric vehicle tariff:** In order to clarify the relevant tariff rate that should apply to hybrid vehicles and fully electric vehicles, new customs categories have been included in the Customs Act to distinguish these vehicles from traditional combustion engine vehicles. An import excise of 20% will apply to hybrid and electric vehicles from 1 January 2021.
- **Reduction of excise on UHT milk:** The increase of UHT milk tariffs to 25% in the 2020 Budget has now been repealed. Treasury stated that this had no practical effect as they had not been applying the excise to UHT imports in any event.
- **Increasing Import Clearance Thresholds:** The threshold which requires Customs clearance on imported goods will be increased from K1,000 to K5,000 in an attempt to lower the customs impost on SMEs. Additionally the minimum level to which duties will be required to be paid is increased to K250 to improve administration.

3.5 Taxing contractors as employees

Finally, the Budget introduces via amendment to the Income Tax Act a new anti-avoidance measure which seeks to prevent employees converting to independent contractors in order to be classified as an SME, and subject to concessional tax arrangements. The inclusion of the relevant provisions in the Salary or Wages division of the Income Tax Act will mean that it has broader implications for taxpayers not only within the SME provisions, and represents legislative drafting of administrative principles that were applied historically by the IRC.

Going forward, the IRC will have the power to treat certain contractors as employees of an organisation, and levy Salary or Wages Tax liabilities where the arrangement includes specific facts. We would encourage those who have engaged independent contractors to review and consider those arrangements to ensure they do not inappropriately mischaracterise them when determining a Salary or Wages Tax liability.

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